

Securities Arbitration: An Idea Whose Time Has Come & Gone? (Part 2)

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[This is the second part of a two-part series on Securities Arbitration. The first part of this article appeared in the September issue of Wall Street Lawyer.]

[Authors' Note: I have tried cases in federal court and state court, including both bench and jury trials in each forum. None of these four settings is nearly as challenging nor physically or mentally as exhausting as trying a case before a binding securities arbitration panel. In an arbitration hearing, the respondent's counsel is deprived of normal opportunities to prepare a defense, faces a grueling schedule during the proceeding, and is likely stuck without the opportunity to appeal an adverse ruling.

The qualitative feel of arbitration is completely different as well. In many ways, a securities arbitration proceeding hardly seems to resemble trial adjudication at all. In Part 1 of this article, I discussed some key differences between trial and arbitrations processes, such as: the daily schedule

during a proceeding; the applicable rules of evidence; the extent of discovery; and the persons qualified to represent the plaintiff. I will now continue that discussion, citing other differences, such as: the availability of summary judgment; the enforcement of statutes of limitation; the right to appeal; and the triers of fact.]

Motions for Summary Judgment

In trial-focused litigation, summary judgment motions are almost universal. If, after a reasonable opportunity for discovery, it is clear that a plaintiff's case has no merit,

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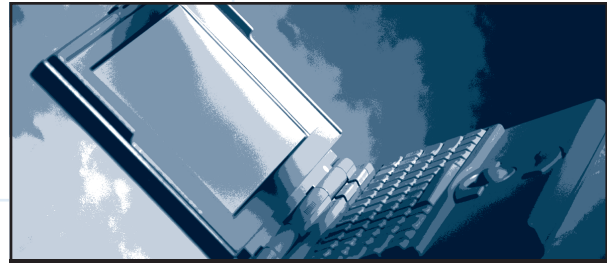
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(ISSN#: 1095-2985)

the defendant can (and likely will) move for summary judgment. The judge, wanting to clear the calendar and resolve the matter efficiently, will grant the motion if it is warranted. If the judge does enter summary judgment, the matter is disposed of much less expensively than if it had gone through to trial. Preparing for trial, filing and arguing motions in *limine*, and appearing in front of the jury is time intensive, and costs the defendant a substantial amount in fees. It goes without saying that the defendant will not incur any of these costs if the claim is cut off at summary judgment.

Motions for summary judgment are almost *never* granted by arbitration panels. In all likelihood, this is due in part to the fact that arbitrators are not always lawyers versed in the prevailing legal standards and are thus uncomfortable denying claimants their day in court, even if their claims are without merit. It is also difficult to reliably grant summary judgment without full discovery, and in court, summary judgment comes when discovery reveals a deficiency in the evidence. But in an arbitration, where the respondent is not allowed to take depositions or discover contentions and key evidence, even a legally trained panelist might be hesitant to grant summary judgment with such a dearth of information. Indeed, it would deny the claimant not only her day in court, but also her chance to litigate the claim in any meaningful way.

Statute of Limitations

Arbitration panels deprive respondents of another important procedural safeguard by declining to enforce statutes of limitation. Every jurisdiction in the country has statutes of limitation, which courts enforce to prevent the litigation of stale claims. When a defendant is forced to defend against a stale claim, it does so at an enormous disadvantage, as it is often exceedingly difficult to track down witnesses and evidence to rebut a plaintiff's testimony based on a long-passed event or set of circumstances.

In court, a claim barred by the statute of limitations likely would not survive summary judgment. But because dispositive motions are rarely granted in arbitrations, violations of the applicable statute of limitations go unchecked and even

time-barred claims usually command a full multi-day hearing in front of an arbitration panel.

In court, however, if a claim potentially barred by the statutes of limitation does slip past summary judgment and does make it to trial, the defendant is allowed to assert an affirmative defense and the jury must rule upon its applicability. This virtually never happens in an arbitration hearing. The NASD -- and now with its merger with NYSE, the Financial Industry Regulatory Authority (FINRA) -- purports to have a six-year "statute of repose,"¹ which would bar all claims related to transactions taking place six years before the arbitration filing. All other applicable statutes of limitation (e.g., three years for fraud, four years for breach of contract, etc.) *should* also be applied. This almost never happens. Any transaction an arbitration client slips in under the six-year statute of repose wire is given almost a free ride to a ruling on the merits. This would never happen in court.

Appeals

Courtroom judges are bound to instruct the jury as to the applicable law, and the jurors must apply that law to the facts before them. If either the judge or jury derelicts its duty, the party adversely affected by it has the right to appeal. Undoubtedly, this is a fundamental part of the judicial process in this country.

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The right to appellate review is non-existent in arbitrations.² Under the Federal Arbitration Act, parties may appeal arbitration awards under only four very limited circumstances: (1) where corrup-

tion, fraud or undue means was used in obtaining the award; (2) where an arbitrator was partial or corrupted; (3) where there was misconduct by the panel in refusing to postpone the hearing, refusing to hear material evidence, or in any other form that prejudiced a party; or (4) where there was misuse of power by an arbitrator.³ Many courts will also hear appeals if it can be proven that panel acted in an “arbitrary or capricious” manner.⁴ In practice, these rules mean that unless one can later prove an undisclosed blood relationship between an arbitrator and one of the parties there is virtually no way to undo an arbitration award, no matter how contrary that award may be to the evidence or common sense.

Even if appellate review of arbitration awards were more freely available, it is unclear that a different outcome would result. Panels are not required to give jury instructions, they are not required to follow the rules of evidence, and they are not required to give any explanation of their reasoning. As the NYSE rules put it: “The arbitrators’ award is not required to include factual findings or legal reasoning...”⁵ And in practice, they seldom justify their conclusions. It is difficult to imagine what arguments might be made on appeal given the absence of any revealed legal error to challenge.

The Triers of Fact

In a jury trial, the triers of fact are quite obviously the jurors. The exact number of jurors ranges from six to twelve depending on the jurisdiction, but is in any event at least double the membership of an arbitration panel. The general public often perceives jurors as foolish, arbitrary, uneducated, and vindictive. To an adherent of that view, wagering at a roulette table provides more predictability than trying to forecast what the jurors might do. On the other hand, the general perception of arbitrators is quite positive. They are seen as learned scholars of the law, perhaps retired judges, law professors, or respected businesspeople well-versed in the virtues of moderation and reason.

In reality, while many arbitrators do fit this lofty description, many fall well short of it. Ar-

bitrators, like juries and lawyers, have biases and preconceptions. Unlike a jury, though, an arbitration panel does not always have the strength in numbers to counterbalance and marginalize any particular member’s predisposition. Also unlike jurors, arbitrators are not always required to disclose any potential biases. Indeed, in conducting *voir dire*, a trial attorney can be disbarred for trying to stack the jury with like-minded individuals. In an arbitration hearing, one party might get that same stacked deck without its counsel taking any affirmative steps to gain the advantage, and more importantly, without the adverse party ever finding out it was playing with a handicap.

The risk of an unsympathetic panel is especially acute for respondents because the claimant’s bar association has done exactly what trial counsel cannot do in selecting a jury. That group, the Private Investors Arbitration Bar Association (PIABA), has undertaken an effort to recruit plaintiff-friendly arbitrators, and it has hired a special consultant to help it do so.⁶ The efforts are publicly apparent on PIABA’s website, where a visitor to the site has easy access to arbitrator applications for both the NYSE and the NASD, and a PDF of the NASD’s informational sheet, which advertises, among other details, the honorarium a person would be paid were they to serve as an arbitrator.⁷

When brokerage firms made the move to binding arbitration, it is hard to imagine they had considered the full spectrum of differences between an arbitration hearing and a jury trial. Indeed, it would have been difficult to predict in advance exactly how the system would evolve in response to increased use. Given the benefit of time, it is now apparent that arbitration and trial-by-jury are quite distinct. The differences that have been explored in this section should give pause to a firm determined to plow on with an unyielding commitment to binding arbitration. If these concerns were not sufficiently troubling, more recent developments seem to undercut the very foundation on which the argument in favor of arbitration was built.

The Fall of Arbitration?

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To begin with, as discussed previously, the simple case seems to be a thing of the past, and matters subjected to arbitration have become increasingly complicated. Furthermore, the unavailability of summary judgment prevents respondents from putting a case to an early, cost-saving end. Instead, they must pay for counsel to prepare for (no quick task considering the fact that counsel does not know in advance what the plaintiff is contending) and appear in a multi-day arbitration in front of a panel whose fees they must pay as well. Certainly, taking the extreme case where a claim violates the statute of limitations, it would cost less to move for summary judgment on those grounds than to try a full arbitration hearing on the merits. The calculation is not always this simple, but the statute of limitations example is illustrative of the point that arbitration is not always cheaper.

Admittedly, the absence of discovery eliminates a sizeable portion of the cost of litigating a claim. However, in federal court and many state courts many discovery disclosures are now mandatory,⁸ which dramatically reduces the need for costly formal discovery.

Arbitration's procedural gaps, ironically, actually increase litigation costs. For example, it is much cheaper to prepare to cross-examine the plaintiff when defense counsel, by virtue of taking his deposition, already knows what the plaintiff

will say. In an arbitration hearing, the respondent's lawyer, not knowing what the plaintiff's testimony will be, must be prepared for *every possible alternative*, however unlikely each may be.

Moreover, as discussed above, the amounts at issue in arbitrations are no longer incidental. The stakes are every bit as high now in arbitration as in cases tried to a jury. Gone are the days where the respondent's lawyer could "wing it" with the prior assumption that the worst the panel might do is award the claimant some amount in the five figures.

Nor are traditional courts any longer the bastions of runaway verdicts and punitive damages that firms once feared they were. Brokers, in moving to binding arbitration, were concerned that juries consistently identified with the "little people" and not the multi-national brokerage firm. They feared that jurors would act on this bias by awarding excessive compensatory damages and astronomical punitive damages against the corporate defendant. This concern is not as valid today. Customers who take the initiative to raise a dispute are not powerless individuals to whom the average juror can easily relate, but instead are often multi-millionaires with a net worth hundreds of times that of any member of the jury. This typical claimant has invested quite successfully over the years and is merely upset that a new market downturn has adversely affected her ability to make the profits she might have expected in a particular period. Any juror with a 401(k) will have been hit by the same downturn, and might not be so sympathetic to a claimant who has lost money she does not really need while the juror has lost a chunk of her retirement fund.

Furthermore, irrational punitive damages are becoming a thing of the past in such cases. In recent years, the Supreme Court has handed down some important decisions limiting the ability of juries to award punitive damages that have no reasonable or justifiable relationship to compensatory damages.⁹ In fact, in California, the Civil Code bars an award of punitive damages against an employer who is found liable on a pure theory of *respondeat superior*.¹⁰ No punitive damages will be so assessed unless the employer had notice of an employee's "unfitness ... and employed him or her with a conscious disregard of the rights or safety of others or authorized or ratified the wrongful conduct ... or was person-

ally guilty of oppression, fraud, or malice.”¹¹ If the employer is a corporation, the behavior triggering the exception (and thus allowing punitive damages) must have been that of a director, officer, or managing agent of the corporation. The significance of this for brokerage firms is that they are incredibly unlikely to be hit with punitive damages for the actions of any individual salesperson or other employee.

Conclusion

Although brokerage firms initially viewed arbitration as something of a panacea, its benefits have always been taken at the expense of procedural safeguards. The advantages of arbitration have been further whittled away over the past two decades, and the future looks like it might bring about more of the same.

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The merger of the regulatory units of NASD and NYSE into FINRA means that there remains only a single arbitration forum, which must reconcile the different sets of rules established in its two predecessors.¹² Investor advocates seem to view the merger as an opportunity to bring about reform in the arbitration process, including moving away from the current requirement that one of the three arbitrators be affiliated with the securities industry.¹³ Although FINRA has adopted the NASD procedural rules¹⁴ these proposals illustrate an important point: despite the fact that brokerage firms face an already thin set of procedural safeguards in arbitration, the process is nonetheless viewed as unfair by individual investors, and brokers risk losing what protections they do have if these activists are successful.

Binding arbitration might still be the right choice for securities firms on the whole. Arbitration is

still a better fit in some cases, but the number of cases where arbitration is clearly advantageous is dwindling. The days where arbitration was a slam dunk decision are over, and any prudent firm must take a hard look at reforming its practices. Perhaps change is appropriate for some firms and not for others; perhaps a firm will choose to require arbitration on some types of securities, but not for others; and perhaps firms will choose to wait it out and see what the future holds. In any event, in preparing this article, I have sought to provide an initial basis on which these decisions can be considered, reconsidered, and eventually made. After all, in the securities business, as in the practice of securities law, it is the firm that accepts the *status quo* without a second thought that at best falls behind its competitors, and at worst....

NOTES

1. NASD, Code of Arbitration Procedures for Customer Disputes § 12206 (as amended Apr. 16, 2007).
2. NASD, Code of Arbitration Procedures for Customer Disputes § 12904(b) (as amended Apr. 16, 2007) (“Unless the applicable law directs otherwise, all awards rendered under the Code are final and are not subject to review or appeal.”); NYSE Group, Inc., Arbitration Rules, Rule 627(b) (“Unless the law directs otherwise, all awards rendered pursuant to this Code shall be deemed final and not subject to review or appeal.”).
3. Codified as 9 U.S.C. § 10(a).
4. See, e.g., *Montes v. Shearson Lehman Bros., Inc.*, 128 F.3d 1456, 1459 n.3 (11th Cir. 1997).
5. NYSE Group, Inc., Arbitration Rules, Rule 636.
6. Karen Donovan, *Fix Arbitration Now*, Registered Rep., Jan 1, 2007 available at http://registeredrep.com/issue_20070101.
7. Available at <http://www.piaba.org>.
8. See, e.g., Fed. R. Civ. P. 26.
9. See, e.g., *BMW v. Gore*, 517 U.S. 559 (1996); *State Farm Auto. Ins. v. Campbell*, 538 U.S. 408 (2003).
10. Cal. Civ. Code § 3294(b).
11. *Id.*
12. Consolidation of NASD and the Regulatory Functions of the NYSE: Working Towards Improved Regulation: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the H. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. (2007) (statement of Joseph P. Borg, Director, Alabama Securities Commission & President, North American Securities Administrators Association, Inc).
13. See *id.*
14. FINRA, *Arbitration & Mediation*, available at <http://www.finra.org/ArbitrationMediation/index.htm> (“FINRA will administer all arbitration and mediation cases filed on or after August 6, 2007 using the NASD Code of Arbitration Procedure.”).